Nos. 712 and 804.

Office Supreme Court
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IN THE

Supreme Court of the United States,

OCTOBER TERM, 1925.

NEW YORK LIFE INSURANCE COMPANY,
Petitioner,

against

WILLIAM H. EDWARDS, as Collector of Internal Revenue for the Second District of New York,

AND

WILLIAM H. EDWARDS, as Collector, etc.,
Petitioner,

against

NEW YORK LIFE INSURANCE COMPANY.

PETITION FOR REHEARING.

JAMES B. McINTOSH,
Attorney for Petitioner,
New York Life Insurance Company.

Law Journal Press Co., Printers, 120 Fulton St., New York, N. Y.

SUPREME COURT OF THE UNITED STATES.

Nos. 712 and 804.—October Term, 1925.

New York Life Insurance Company, Petitioner, 712 *vs.* William H. Edwards, as Collector of Internal Revenue, etc.	On Writs of Certiorari to the United States Circuit Court of Appeals for the Second Circuit.
William H. Edwards, as Collector of Internal Revenue for the Second District of New York, Petitioner, 804 *vs.* New York Life Insurance Company.	

[April 19, 1926.]

Mr. Justice McReynolds delivered the opinion of the Court.

The Insurance Company brought suit in the District Court at New York to recover of Edwards, Collector, the alleged excessive sum demanded of it as income tax for the year 1913 and obtained judgment for a part. 3 Fed. (2d) 280. The Circuit Court of Appeals affirmed this except as to one item. 8 Fed. (2d) 851. Both parties are here by certiorari, and five questions require consideration. All involve the construction or application of the Revenue Act of October 3, 1913, c. 16, 38 Stat. 114, 172. Section II G (a) imposed an annual tax of one per centum upon the net income of "every insurance company organized in the United States," and (b) directed—

> Such net income shall be ascertained by deducting from the gross amount of the income of such . . . insurance company, received within the year from all sources, (first) all the ordinary and necessary expenses paid within the year in the maintenance and operation of its business and properties, including rentals or other payments required to be made as a condition to the continued use or possession of property; (second) all losses actually sustained within the year and not

> compensated by insurance or otherwise, including a reasonable allowance for depreciation by use, wear and tear of property, if any; . . . and in case of insurance companies the net addition, if any, required by law to be made within the year to reserve funds and the sums other than dividends paid within the year on policy and annuity contracts: *Provided*, That . . . life insurance companies shall not include as income in any year such portion of any actual premium received from any individual policyholder as shall have been paid back or credited to such individual policyholder, or treated as an abatement of premium of such individual policyholder, within such year. . . .

1. The Company, a New York corporation without capital stock, does business on the mutual, level premium plan and issues both "annual dividend" and "deferred dividend" policies. Under this plan each policyholder pays annually in advance a fixed sum which, when added to like payments by others, probably will create a fund larger than necessary to meet all maturing policies and estimated expenses. At the end of each year the actual insurance costs and expenses incurred are ascertained. The difference between their sum and the total of advance payments and other income, then becomes the "overpayment" or surplus fund for immediate *pro rata* distribution among policyholders as dividends or for such future disposition as the contracts provide. An "annual dividend" policyholder receives his proportionate part of this fund each year in cash or as a credit upon or abatement of his next premium. "Deferred dividend" or, as sometimes called, "distribution" policies provide—

> That no dividend or surplus shall be allowed or paid upon this policy, unless the insured shall survive until completion of its distribution period, and unless this policy shall then be in force. That surplus or profits derived from such policies on the distribution policy plan as shall not be in force at the date of the completion of their respective distribution periods, shall be apportioned among such policies as shall complete the distribution periods.

Accordingly, all overpayments by deferred dividend policyholders must await apportionment until the prescribed period ends; and no one of them will receive anything therefrom if his policy lapses

or if he dies before that time. The whole of this fund goes to the survivors.

Overpayments by deferred dividend policyholders for 1912 amounted to $8,189,918. The Collector refused to deduct this sum from the total receipts, and demanded the prescribed tax of one per centum thereon. We think he acted properly. Both courts below so held.

The applicable doctrine was much considered in *Penn Mutual Life Insurance Co.* v. *Lederer*, 252 U. S. 523. We there pointed out the probable reason for the permitted non-inclusion in the net income of a life insurance company of "such portion of any actual premium received from any individual policyholder as shall have been paid back or credited to such individual policyholder, or treated as an abatement of premium of such individual policyholder, within such year." Here it is insisted that within the meaning of the quoted provision each deferred dividend policyholder's overpayment was actually credited to him during the year; but we cannot accept this theory. The aggregate of all such payments was held for distribution among policyholders alive at the end of the period. The receipts for the year were not really diminished.

2. The Company owned many bonds, etc., payable at future dates, purchased at prices above their par values, and to amortize these premiums a fund was set up. It claimed that an addition to this fund should be deducted from gross receipts. The District Court thought the claim well founded, but the Circuit Court of Appeals took another view. Unless the addition amounted to a loss "actually sustained within the year" no deduction could be made therefor. Obviously, no actual ascertainable loss had occurred. All of the securities might have been sold thereafter above cost. The result of the venture could not be known until they were either sold or paid off.

3. In 1910 the Company introduced a clause into some policies by which it agreed to waive payment of premiums after proof of total and permanent disability. The estimated value on December 31, 1913, of future premiums so waived amounted to $16,629. It claimed this should be added to the reserve fund and deducted from gross income. Insurance companies may deduct "the net

addition, if any, required by law to be made within the year to reserve funds."

The pertinent portion of the agreed statement of facts follows—

In 1910 the plaintiff introduced into some of its contracts of life insurance a clause under which it agreed that upon receipt, before default in the payment of premium, of due proof that the insured had become totally and permanently disabled, the plaintiff would waive payment of any premium thereafter falling due. In taking its account at the end of the calendar year 1913, the plaintiff had then received due proof that the insured under a number of these policies were totally and permanently disabled in accordance with the terms of said contracts providing for the waiver of the payment of future premiums. The value at December 31, 1913, of the future premiums waived on account of total and permanent disability was the sum of $16,629. The value at December 31, 1912, of the future premiums so waived was the sum of $5,637.

In the calculation of the general reserve fund at the end of any calendar year, the Company and the Insurance Department of the State of New York make the computation by deducting from the value of the contractual benefits under each policy the then value of all future premiums under the policy. The general reserve fund of the plaintiff stated in its Annual Statement is thus the reserve computed by deducting the value of all future premiums from the valuation of all policy obligations. But, under the policies on the lives of those who had become totally and permanently disabled and whose contracts provided for the waiver of the payment of future premiums, no future premiums will be received by the plaintiff and therefore, the net reserve reported for these policies is understated to the extent of the value of these future premiums.

In the official blank for the plaintiff's Annual Statement to be used at December 31, 1913, there was an item of liabilities, #9-*a* entitled, "Present Value of Future Premiums Waived on Account of Total and Permanent Disability," and in the plaintiff's Annual Statement the sum reported under this item was $16,629 at December 31, 1913. The sum of $16,629 re-

ported under Item #9-*a* was not included in the plaintiff's general reserve. In the official blank for use at December 31, 1912, there was no such item as #9-*a*, and the plaintiff included the value at December 31, 1912, of future premiums waived on account of total and permanent disability (viz: $5,637) as a part of the general reserve at that date.

If said sum of $5,637 had not been included as a part of the general reserve at December 31, 1912, the net addition to the value of future premiums waived on account of total and permanent disability would have been the excess of $16,629 over $5,637. Since, however, owing to the change in the form of the official blank, the said $5,637 was deducted as a part of the plaintiff's general reserve in obtaining the net addition to the general reserve, the sum to use in obtaining the net addition to the value of future premiums waived on account of total and permanent disability in the sum of $16,629.

The Circuit Court of Appeals held the deduction should have been allowed, but we think otherwise.

The Superintendent of Insurance of New York required this item to be reported as a liability and did not treat it as part of the general reserve. Upon the agreed facts we cannot say that it was part of any reserve required by the laws of New York. There is nothing to show how "the value of the contractual benefits" under these policies was arrived at and, considering the evidence presented, we must accept the Superintendent's conclusion. The Company has not shown enough to establish its right to the exemption.

4. A number of policyholders died during the calendar year, but their deaths were not reported before it terminated. The Superintendent of Insurance required the Company to set aside a special fund to meet these unreported losses, and it claimed that this was an addition to the reserve fund required by law. We think this claim was properly rejected by the Commissioner, although the courts below held otherwise. *McCoach* v. *Insurance Co. of North America*, 244 U. S. 585, and *United States* v. *Boston Insurance Co.*, — U. S. — [November 23, 1925], pointed out that "the net addition, if any, required by law to be made within the year to reserve funds," does not necessarily include whatever a state official may so designate; that "reserve funds" has a technical

meaning. It is unnecessary now to amplify what was there said. The item under consideration represented a liability and not something reserved from premiums to meet policy obligations at maturity.

5. The Company also claimed deduction for additions to a fund set aside to provide for payment of annuities to former soliciting agents as provided by their contracts of employment. The Commissioner properly rejected this item, although both courts below held a different view. The agreed statement of facts shows—

> The plaintiff has a form of contract of employment with many of its soliciting agents under which, if such agents for a period of twenty years continuously devote their entire time, talents and energies in soliciting applications for insurance, and if they shall for the twenty years accomplish certain prescribed minimum results, then at the end of twenty years of such service each such agent becomes entitled to an income for life payable monthly, the amount of the payment being based upon the results obtained by each such agent during the twenty year period. The laws of New York require the Superintendent of Insurance, in making a valuation of the obligations of the plaintiff, to value annuities on the standard of McClintock's "Table of Mortality among Annuitants", with interest not exceeding four per centum per annum. Said Superintendent of Insurance after making an examination of the plaintiff and valuing its liabilities, required the plaintiff to carry, and it does carry, a fund to meet its said liabilities on said contracts with its soliciting agents; and this fund it increased during the year 1913. The net addition to said fund for said year was the sum of $160,641, which the plaintiff, in making its said return deducted from gross income under that clause of the law which authorizes a life insurance corporation to deduct the net addition required by law to be made within the year to reserve funds. But in amending said return the Commissioner refused to allow said deduction, and thereby made the plaintiff's net income for the year appear to be $160,641 more than it would have been if said deduction had been allowed, and he assessed and collected an additional tax on account thereof accordingly in the sum of $1,606.41, which forms a part of the tax in controversy in this suit.

As pointed out above, the term "reserve funds," in the taxing Act, has a technical meaning. The compensation which an insurance company agrees to pay soliciting agents has no relation to the reserve held to meet maturing policies; and when it sets aside a fund to provide payments to such agents this cannot be regarded as a reserve within intendment of the statute.

The judgment below must be reversed. The cause will be remanded to the District Court for further proceedings in harmony with this opinion.

A true copy.

Test:

Clerk, Supreme Court, U. S.

Nos. 712 and 804.

IN THE

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OCTOBER TERM, 1925.

NEW YORK LIFE INSURANCE COMPANY,
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AGAINST

WILLIAM H. EDWARDS, as Collector of Internal Revenue for the Second District of the State of New York,

and

WILLIAM H. EDWARDS, as Collector, etc.,
Petitioner,

AGAINST

NEW YORK LIFE INSURANCE COMPANY.

PETITION FOR REHEARING.

NEW YORK LIFE INSURANCE COMPANY petitions the Court for a rehearing of the above cases and says:

FIRST. As to "the net addition, if any, required by law to be made within the year to reserve funds".

1. Reserve on policies providing for waiver of premium and disability benefits.

No dispute has ever existed about the amount of this reserve. Hence there was no reason for stating how the amount of it was arrived at.

It is a reserve required by law because Section 84 of The New York Insurance Law says,—"The superintendent of insurance shall annually make valuation of all outstanding policies". Waiver of premium and disability benefits are a part of the company's policy contract liability, just as much so as is the death loss.

Section 84 also says,—

> "The superintendent may vary the standards of interest and mortality in particular cases of invalid lives and other extra hazards."

Section 46 of The New York Insurance Law requires the Superintendent to make an Annual Report to the legislature of the business of his office. In his 1912 Annual Report, Volume V, page 168, the Superintendent said,—

> "In accordance with the following provisions of Section 84 of the Insurance Law, 'The Superintendent may vary the standards of interest and mortality in particular cases of invalid lives and other extra hazards', etc., *the Superintendent adopts for the valuation of waiver of premiums and permanent disability, Arthur Hunter's 'Tables of Rates of Disability and of Mortality among Disabled Lives', combined with American Experience Table of Mortality with Interest at 3 per centum per annum.*"

Carrying out the law as thus set forth, the Superintendent calculated the reserve value of the future premiums waived for total and permanent disability on policies outstanding at December 31, 1912 and 1913, and found the true reserve to be $5,637 at December 31, 1912, and $16,629 at December 31, 1913. The difference was the net addition to this policy reserve.

The Record says (p. 26),—

> "For more than twenty-five years last past the plaintiff has been duly licensed to transact its said business of life insurance in the several states, territories and possessions of the United States, in the District of Columbia and in many foreign countries."

The Massachusetts law, which means the same thing as the New York law and is equally binding on the company, states the requirement for this reserve as follows,—

> "Section 9. He (the Superintendent of Insurance) shall each year compute the reserve liability on December thirty-first of the preceding year of every company authorized to make insurance on lives in the commonwealth, in accordance with the following rules:
>
> * * * * * *
>
> "Fifth. The reserve liability for the total and permanent disability provision incorporated in policies of life insurance shall be computed on the basis of 'Hunter's Disability Table', or any similar table approved by the commissioner, with interest not exceeding three and one half per cent per annum".
>
> *General Laws of Massachusetts*, Vol. 2, page 1950.

The Wisconsin law is substantially the same, as follows,—

> "SECTION 1950*g*. Reserve basis; total and permanent disability benefits. The reserve liability for the total and permanent disability provision incorporated in policies of life or endowment insurance shall be calculated on the basis of 'Hunter's Disability Table', or on any table based upon disability experience approved by the commissioner of insurance, with interest at not exceeding three and one-half per cent per annum".
>
> *Wisconsin Laws*, Section 1950*g*.

These features of the policy reserve were of slight importance in 1913 because the companies had just then first made these benefits a part of its policy contracts. The insuring public, however, favorably received them, so that they are now of much importance.

2. Reserve for annuities on the lives of agents.

The reason why the law required the company to carry a reserve on these annuities was because they were annuities,—not because of the persons to whom the annuities were payable, nor because of the way each annuitant purchased and paid for his annuity.

As matter of fact the agents bought these annuities and paid for them by foregoing the customary renewal commissions that otherwise would have been payable to them and been deducted as an expense of management from the company's gross income for the year. The annuities are payable to them, not because they are working for the company, not at all. Like any other annuity, they are payable whether the agents are working for the company or not. They are payable because the agents bought them and paid for them.

The details of this are not in the Record, but why should they be? The law requires the company to hold a reserve to meet its annuity obligations,—not because of the occupation, color, race or condition of the persons to whom the annuities are payable, nor because of the consideration paid for them; but solely because its outstanding annuities are a "contingent liability" of the company which Section 84 of The Insurance Law of New York requires the company to hold a reserve to meet.

There is no difference between these annuities and any other annuity. If it were a matter of importance here, which it is not, there is no difference between these annuitants and any other annuitant. The important thing here is that these annuities, like any other annuity, are a "contingent liability" which Section 84 of The Insurance Law and the Superintendent of Insurance require the company to be prepared to meet by holding "such funds as are technically known and universally understood in the insurance world as reserve funds".

United States v. *Boston Insurance Co.*, U. S. (November 23, 1925).

3. Reserve for losses incurred but unreported.

We make no criticism of the *McCoach* case or of the *Boston Insurance Company* case. They related to sums set aside to meet losses which were known to have happened. We have such items, but claim no reserve for them. The question in

dispute in those cases is not at all the question in dispute here.

In our 1913 Annual Statement are two liability items such as were before the Court in the *McCoach* and *Boston Insurance Company* cases, namely, (1) "Claims for Death Losses in process of adjustment, or adjusted and not due, $1,066,359.93," (2) "Claims for Death Losses reported for which no proofs have been received, $1,761,714.26". It was items such as these that were in dispute in the *McCoach* and *Boston Insurance Company* cases. They are liabilities and have no "reference to the funds ordinarily held as against the contingent liability on outstanding policies". The reserve in dispute here is quite a different subject.

The net addition to reserve which we claim the benefit of here is a part of the policy reserve set aside to meet an unknown but a contingent liability. The law and the Superintendent of Insurance require the company to hold this reserve for this reason;—the main policy reserve, calculated on a prescribed mortality table and a given rate of interest, assumes that all the insured are alive. We know, however, that some of the insured must be dead, but how many or who are dead we do not know. Hence, the main policy reserve, calculated on the mortality table and at the assumed interest rate, is too small. It does not equal the company's contingent policy liability. It would not reinsure its risks. Therefore, to make up the full reserve and cover "the contingent liability on outstanding policies", the law requires the company to hold, and it does hold, an additional sum as reserve to meet this unknown and contingent liability on its policies. This sum plus the mathematical reserve constitutes each year the full policy reserve.

The form which, pursuant to Section 44 of The New York Insurance Law, the Superintendent prepares and furnishes the company for its annual report, calls this supplemental policy reserve, "Reserve for net Death Losses incurred but unreported". And the Superintendent calculates the amount

of it, and he and the law require the company to hold it because its policy reserve would be incomplete without it.

SECOND. "and life insurance companies shall not include as income in any year such portion of any actual premium received from any individual policyholder as shall have been paid back or credited to such individual policyholder, or treated as an abatement of premium of such individual policyholder, within such year".

(*a*) What is the important thing in this clause? *Portion of actual premium received* is the important thing,—not what was done with it. The portion of actual premium received in excess of insurance cost is not to be included in income, no matter what was done with it; that is, whether it was paid back, or credited, or treated as an abatement of premium. Why? Because it was not income of the company. The *Mutual Benefit* case commented on in my brief commencing on page 22 made this clear. The portion of the premium received in excess of the cost of insurance belonged to the policyholder, not to the company. There was no circumstance in which the over-payment belonged to or was income of the company. It was bound to give it back both on the principles of mutual insurance and by the terms of all its contracts. Even if it held it for a time, as it did under the so-called deferred dividend policies, it was bound to return it all with interest. No portion of the premium belonged to the company except the cost of insurance. That and that only was the company's income from its policyholders.

(*b*) But we have gotten away from the important thing in the clause by fixing our attention on the unimportant, namely, when and how the company, after ascertaining the cost of insurance, gave back his own money to the insured.

(*c*) Fixing our attention on the unimportant and not on the important part of the clause, a dictum in the *Penn Mutual*

case, involving a different sum, with wholly different grounds to support the decision, is used to defeat the just merits of this case, a dictum, too, which I think has been misunderstood.

The difference between the issue in the *Penn Mutual* case and in this case is shown in my brief commencing on page 29.

The law authorizes the deduction of "sums *other than dividends* paid within the year on policy and annuity contracts". The sum in dispute in the *Penn Mutual* case was "dividends paid within the year". The plain language of the law, therefore, was reason enough for the decision in that case, and, as I understand the opinion, it gives that reason.

But a general expression in the *Penn Mutual* case not necessary to the Court's conclusion, namely, "The principle applied is that of basing the taxation on receipts of net premiums instead of on gross premiums", was used to beat us below, and now, as I understand the Court's opinion, is used to beat us here because "The receipts for the year were not really diminished" by the over-payments in question.

Now let us look at this dictum and see if there is anything in it to justify the effect it has had in this litigation. "The principle applied is that of basing the taxation on receipts of net premiums". In life insurance, net premium has a well understood meaning. Net premium is the gross premium less the loading. I am sure net premium is not used in the *Penn Mutual* case in this sense. As used there it means the cost of insurance, the net sum used in each premium to pay for insurance. This is just what we claim for this clause of the law. Because what we claim here is, and it is our whole claim, namely, that the premium income of the company which is to be used as the basis for the tax is the amount of the gross premiums less the over-payments; that is, the taxable sum is the cost of insurance. The principle applied is that of basing the taxation on net premiums, using the expression net premiums in the sense of cost of insurance. For this and this alone is income of the company.

(*d*) Nor is there anything in this statute to justify restricting the portions of actual premiums received which are not to be included in income to those only that diminish the receipts of the company for the year.

No credited over-payment diminishes the receipts for the year. Suppose these policies had provided that each annually ascertained over-payment should be held to the credit of the policyholder for five years, would such credit have diminished the receipts for the year?

Annual dividend policies say over-payments may be left with the company (R. 99) to "accumulate to the credit of the policy, with compound interest at the rate of three per centum per annum, and payable at the maturity of the policy, but withdrawable on any anniversary of the policy". Policyholders often leave them to be so held. More than $10,000,000 of such over-payments were left with the company last year under this clause of the policy. Did any of these diminish the company's receipts for the year?

(*e*) But you say you cannot accept the theory that these over-payments were credited during the year.

That they were credited to each individual policyholder within the year is not a *theory*, it is a *fact*. If it was not a fact, then why did not the company stop after its accounting disclosed (R. 41 *et seq.*) that its deferred dividend policyholders had over-paid it $8,189,918?

If they were not credited, then why did the company, after ascertaining their total amount, go to the enormous labor and expense of distributing this total sum (R. 42 *et seq.*) among its deferred dividend policyholders by a mathematical calculation based on the amount of deferred dividend insurance in force, the year of issue of the several policies, the plan of the policy, and the age at issue? If they were not credited, why did the company, after distributing the total over-payments to its several deferred dividend policyholders, make (R. 44) a formal record of the sum over-paid by each policyholder for each $1,000 of his insurance? If they were not credited, why does the company on the dividend date named

in his policy pay each policyholder (R. 49) the total amount shown by Exhibit 5 of these annually ascertained and distributed over-payments, with interest, plus his proportionate share of the like credits of policyholders of his class whose credits were lost to them by the happening of a condition subsequent, namely, his death or the lapse of his policy before the dividend date named in it?

(f) But the Court says, "all over-payments by deferred dividend policyholders must await apportionment until the prescribed period ends".

Why? The policy does not say so. It says *dividends* shall not be allowed or paid until the end of the prescribed period; and that the over-payments of policyholders whose policies are not in force on their dividend date shall be apportioned among the policies of the class that are. The policy says nothing at all about the annual ascertainment, distribution, or credit of the annual over-payments.

On the contrary, the company understands, and has always understood, that the principles of mutual insurance as well as the insurance laws require this distribution and credit each year. That is why, after ascertaining the gross sum overpaid, it made the complicated and laborious distribution, and gave each policyholder the credit illustrated by Exhibit 5.

A Wisconsin law, which the company is required to keep, passed in 1907, Chapter 636, illustrates the meaning, purpose and intent of what the company did about these over-payments after ascertaining the total amount of them. That law says,—

> "On all participating policies heretofore or hereafter issued in this state . . . under the conditions of which the distribution of profits, earnings or surplus is deferred for more than one year from the date of the policy, and contingent on the policy being in force and the insured living at the completion of the period for which such distribution is deferred, *the company shall annually ascertain and credit the share of each such policy in the profits, savings, earnings or surplus.*"
>
> *Wisconsin Statutes, 1911,* Section 1952*b*.
>
> *Wisconsin Statutes, 1923,* Chap. 206, Sec. 206.36.

It was the Wisconsin Insurance Commissioner's duty to revoke the company's license to do business in that state if it failed to keep this law.

Wisconsin Statutes, 1911, Section 1955.

But the Wisconsin Commissioner has always been satisfied, as the company has always intended and claimed, that what it did each year after determining the total over-payments made by deferred dividend policyholders constituted an annual ascertainment and credit of the share of each policyholder in the over-payments of premiums made the year before.

Moreover, a section of this same statute which Wisconsin passed in 1907 required the company to send to each Wisconsin policyholder, yearly, at least thirty and not more than sixty days before the due date of the premium, a statement of the amount of over-payment made by him the year before and credited to him, the amount of his total credits and the rate of interest they draw. The form printed at page 50 of the Record, approved by the Wisconsin Insurance Commissioner, was used for this purpose.

Wisconsin Statute, 1911, Section 1952*d*.

Now if we are all of us all wrong about this, we have been wrong a long, long time; and the consequences are obviously more serious than even the amount of these taxes. If we are wrong, then for nearly twenty years the company has been doing business in Wisconsin in violation of its laws. It has incurred in Wisconsin heavy penalties, and besides it is the duty of the Wisconsin Commissioner now, as it was his duty long ago, to revoke the company's authority to do business in Wisconsin. In the circumstances is it unreasonable that we should ask why we are wrong? The company must have meant something by what it did. What could it have meant if it did not mean what we say it meant?

(*g*) But the defendant criticises our way of keeping the credit. He thinks we ought to carry it to a card because we

carry the over-payment on annual dividend policies to the premium notice card. We do this solely because notice of the amount must go out with the premium notice, and carrying it to the premium notice card is the practical way of preparing and sending the notice. This is the sole object and purpose of carrying the over-payments to any card (R. 43, fols. 128 *et seq.*). The original entry, the original record, is Exhibit 5; all others are copies of that.

This subject is discussed in my brief commencing on page 33.

In addition to what I say there, let me ask,—What card would you transfer them to? There are more than a half dozen cards for each policy, in as many different departments. Obviously you could not carry them to the premium notice card without incurring a world of confusion and mistakes. The same is true of every other card. No card has all the facts about any policy. Each card has only the record on it pertinent to the work of the department which keeps it.

(*h*) If it be said this credit record requires explanation and reference to other records, the answer is,—So does every record the company keeps. It is its records as a whole and in all departments taken and read together that constitute the record of each policy.

To illustrate this, take the premium card about which it is agreed in this record (p. 49),—"When the policyholder pays each premium, the plaintiff immediately credits him individually on his premium card with the premium he paid". I have before me a representative premium card of a going policy that I wish it were practicable to show to the Court. It would take more than a printed page to recite the record contained on this card. And yet nobody that did not know how the company keeps its records could make head or tail of it. The only entry the company made on the card to show credit for premiums paid was to stamp with a rubber stamp in the proper place the date of payment, "Dec 5 22", "Nov 21 23", and so for each payment. The amount credited is not entered, but the amount of the premium was typewritten

on the card when the company wrote the policy. The word credit or debit or other similar word is not on the card. The card does not contain either the full name or any address of the insured; it contains the number of the policy and any one wanting the name and address of the insured must consult another card in another department where names and addresses are recorded.

In other words, no one policy record in this or any other large insurance company is complete in itself. To be transacted efficiently at all, the business must be done in parts and in departments, the records in all departments constituting the complete record of any and every policy. Hence, the volume from which Exhibit 5 is taken, when read as every other record must be read, in connection with the records in every department, is a complete and perfect credit to each individual policyholder of the over-payments made by him in 1912 and credited at the accounting in 1913.

(*i*) The records of every enterprise must be taken to mean what the concern that made them meant by them. By distributing the over-payments and recording the sum overpaid to each policyholder for each $1,000 of his insurance the company meant and could only mean such record, taken with its other records, as a credit to each individual policyholder of the over-payment made by him, because the principles of mutual insurance require it, the laws of some of the states where it does business impose upon it the duty *annually* to "*ascertain and credit* the share of each such policy in the profits, savings, earnings or surplus", all public officials accept what it does as such ascertainment and credit, and no one ever questioned it until it is now for the first time questioned in imposing a tax which Congress by language which is so plain that it ought not to be misunderstood did not intend to impose, and which cannot stand if any meaning at all is to be given to the word "credited".

Congress wholly exempted from the income tax mutual savings banks, *Federal Statutes Annotated*, *Vol. 4, page*

245. What is there to indicate they intended to be severe on mutual life insurance, or to discriminate between mutual companies? The funds of such companies are more important, more sacred, than are the funds of mutual savings banks. Twenty years ago the public mind was in complete accord on this. The strong sentiment that obtained in Congress on this subject is indicated by the report of the Finance Committee of the Senate on the Bill for the War Revenue Act of 1917, where they said at page 11,—

> "The House Bill contains a provision taxing insurance of various kinds. The principle of imposing excise taxes on insurance is questionable. In the case of life insurance the insured makes a sacrifice during his life for the benefit of his family after his death. In the case of many other kinds of insurance he makes an expenditure for the safeguarding of his property. Transactions of this kind should not be subjected to tax except in the last resort."

WHEREFORE, NEW YORK LIFE INSURANCE COMPANY prays for a stay of the mandates in these two cases, that the judgments therein may be vacated and set aside and a rehearing granted, and for such other and further relief as may be just and equitable.

NEW YORK LIFE INSURANCE COMPANY,
By JAMES H. MCINTOSH,
Its Attorney.

I, JAMES H. MCINTOSH, do hereby certify that I am counsel in the above entitled cases for New York Life Insurance Company, the petitioner, and that the foregoing petition for a rehearing is presented in good faith and not for delay.

JAMES H. MCINTOSH.

Dated at New York,
May 12, 1926.

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In the Supreme Court of the United States

OCTOBER TERM, 1925

No. 712

NEW YORK LIFE INSURANCE COMPANY, PETITIONER

v.

WILLIAM H. EDWARDS, AS COLLECTOR OF INTERNAL REVENUE, etc.

No. 804

WILLIAM H. EDWARDS, AS COLLECTOR OF INTERNAL REVENUE, etc., Petitioner

v.

NEW YORK LIFE INSURANCE COMPANY

ON WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE COLLECTOR

OPINIONS BELOW

The case in the District Court is reported in 3 Fed. (2d), page 280, and is found in the record at page 126. The case in the Circuit Court of Appeals is reported in 8 F. (2d), page 851, and the opinion of that court is found in the record at page 156.

JURISDICTION

The judgment of the District Court was entered December 15, 1924 (R. 22), and that of the Circuit Court of Appeals on August 6, 1925 (R. 177). The jurisdiction of this Court was invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925, c. 229, 43. Stat. 936.

STATEMENT

The case involves certain income-tax provisions of Section II G (b) of the Revenue Act of October 3, 1913, c. 16, 38 Stat. 114, 172.

The New York Life Insurance Company, after claim for refund had been denied, sued Edwards, as Collector of Internal Revenue, in the District Court of the United States for the Southern District of New York, to recover the sum of $90,556.19, with interest, representing the amount of additional income tax for the year 1913 alleged to have been illegally assessed and paid under protest. The case was tried before Honorable Julian W. Mack, Circuit Judge, upon an agreed statement of facts. Included in the amount sued for were the three following items, which are those here involved:

(1) $81,899.18. This represents a tax upon the sum of $8,189,918, the amount of overpayments of premiums made by the insurance company's deferred dividend policyholders in 1912, and ascertained, but not distributed in 1913. The company

claimed that under the provisions of Section II G (b) of the Revenue Act of 1913 that sum was, by the process of "noninclusion," deductible from its gross income for 1913. The Commissioner ruled otherwise, and imposed in respect thereto a tax of $81,899.18. The District Court directed a verdict in favor of the Collector, and the company excepted. (R. 124.) Upon this item the judgment of the District Court was affirmed by the Circuit Court of Appeals. The company seeks review in No. 712.

(2) $3,324.67. This represents a tax upon the sum of $332,466.72, the amount of a deduction for the year 1913 for amortization of securities purchased by the company at a premium. The collector refused to allow this as a deduction. Upon this item the District Court directed a verdict in favor of the company, and the collector excepted. (R. 124.) The Circuit Court of Appeals reversed the District Court and the company seeks review in No. 712.

(3) $4,272.70. This sum represents a tax upon $427,270, claimed by the company to be a net addition required by law to be made within the year to "reserve funds," within the meaning of the statute. The total, $427,270, is in turn made up of three amounts:

(*a*) $16,629, the amount added during 1913 to a fund representing "waived premiums" under certain "special benefit disability contracts."

(*b*) $250,000, an addition to a fund representing liability under " unreported loss claims."

(*c*) $160,641, an addition to a fund to meet plaintiff's pension obligations under so-called " Nylic " contracts of employment with certain of the company's soliciting agents.

The company claimed that these amounts were, under the statute, deductible as " reserves." The collector ruled against the company. The District Court directed a verdict in favor of the company, and the collector excepted. (R. 124.) This ruling was sustained by the Circuit Court of Appeals. The Government seeks review in No. 804.

All these items will be more fully explained in the statement of facts which follows.

STATUTE INVOLVED

The relevant portions of the Revenue Act of October 3, 1913, c 16, 38 Stat. 114, are as follows:

> Section G (b) of Section II, 38 Stat. 172:
>
> " Such net income shall be ascertained by deducting from the gross amount of the income of such corporation, joint-stock company or association, or insurance company, received within the year from all sources, (first) all the ordinary and necessary expenses paid within the year in the maintenance and operation of its business and properties, including rentals or other payments required to be made as a condition to the continued use or possession of property; (second) all losses actually sustained within

the year and not compensated by insurance or otherwise, including a reasonable allowance for depreciation by use, wear and tear of property, if any; and in the case of mines a reasonable allowance for depletion of ores and all other natural deposits, not to exceed 5 per centum of the gross value at the mine of the output for the year for which the computation is made; *and in case of insurance companies the net addition, if any, required by law to be made within the year to reserve funds and the sums other than dividends paid within the year on policy and annuity contracts: Provided,* That mutual fire insurance companies requiring their members to make premium deposits to provide for losses and expenses shall not return as income any portion of the premium deposits returned to their policyholders, but shall return as taxable income all income received by them from all other sources plus such portions of the premium deposits as are retained by the companies for purposes other than the payment of losses and expenses and reinsurance reserves: *Provided further,* That mutual marine insurance companies shall include in their return of gross income gross premiums collected and received by them less amounts paid for reinsurance, but shall be entitled to include in deductions from gross income amounts repaid to policyholders on account of premiums previously paid by them and interest paid upon such amounts between the ascertainment thereof and the payment thereof and *life insurance*

companies shall not include as income in any year such portion of any actual premiums received from any individual policyholder as shall have been paid back or credited to such individual policyholder, or treated as an abatement of premium of such individual policyholder, within such year;" (Italics indicate the particular portions of the section here involved.)

THE FACTS

The agreed statement of facts appears in the record beginning at page 25. From this statement we summarize the essential facts as follows:

I

As to the claim for $81,899.18

The New York Life Insurance Company, plaintiff in the District Court and hereinafter referred to as the plaintiff, is a life insurance corporation of the State of New York. It is a mutual company and its policies are all issued on the mutual, level premium plan. It has neither capital stock nor stockholders. (First paragraph, R. 25, 26.)

The table rate of premium in life insurance on the mutual, level-premium plan is calculated, first, by adopting an accepted table of mortality showing the death rate for each age of life, and, second, an assumed rate of interest which the company may safely expect to realize upon its invested assets for the duration of all its policies. With these two factors it is calculated just what sum each insured

must pay yearly in advance to supply the company with funds sufficient to pay all the outstanding policies as they mature, provided deaths occur in accordance with the table of mortality and the rate of interest earned is the assumed rate. The sum ascertained in this way is called the net or mathematical premium; but this is not the full amount each member must pay, because it contains no provision for expense of management and unforseen contingencies, such as excess mortality, diminished interest, investment losses, increased taxation, and the like. Therefore, there is added to the net premium a sum technically called "loading." The net premium plus the loading constitutes the table rate or " level premium " and is the sum named in the policy as the premium to be paid in advance, to be adjusted to cost when cost is known, and is the maximum sum which the company can ever require the insured to pay. (Twelfth paragraph, R. 40.)

To find the actual cost of insurance for the year the plaintiff, at the end of the calendar year takes an account of its business. During the year 1912, the plaintiff's policyholders paid the premiums called for in their policies, and, as received, the plaintiff credited the amount of the premiums to each individual policyholder in a premium account kept with him. In the accounting at the end of the year, the plaintiff ascertained the amount of its total receipts for the year from which it deducted (1) its policy claims paid for the year; (2) its

current expenses; (3) the sum required to increase its reserve; and (4) the amount required to increase the sum held to meet contingencies; and all sums received in excess of these four items constituted the amount of overpayment of premiums made during the year 1912, which the plaintiff held for return to policyholders in accordance with the terms of their several policies. Plaintiff's account of its business for the year 1912 showed that its policyholders had overpaid it for that year the sum of $13,900,061, of which $5,710,143 was overpaid by "annual dividend" policyholders and $8,189,918, by "deferred dividend" policyholders. (Thirteenth paragraph, R. 40, 41, 42.) The tax of 1 per cent upon this latter sum is the amount involved under this claim. The overpayment made by each annual dividend policyholder was calculated and entered on a card, and he was notified of the amount of his dividend payable on the anniversary of his policy. (Fourteenth paragraph, R. 42, 43, 44.)

But in the case of the deferred dividend policies the plaintiff did not, as in the case of annual dividend policies, multiply the ascertained overpayment rate for each $1,000 of insurance by the amount of insurance in force under each policy and record the product on a card. It merged said total overpayments, namely, the sum of $8,189,918, into an account called in its report to the Insurance Department, "Amount set apart, apportioned, pro-

visionally ascertained, calculated, declared or held awaiting apportionment upon deferred dividend policies," which amount recorded the accumulated overpayments of all deferred dividend policies, except those on which a dividend was payable during the accountancy year, in the present case the calendar year 1913. After the plaintiff had added the said sum of $8,189,918, the total amount carried in that account was $85,142,216. (Fourteenth paragraph, R. 44.)

The difference between an annual dividend policy and a deferred dividend policy is illustrated and explained in the fifteenth, sixteenth, and seventeenth paragraphs of the agreed statement of facts. (R. 45–49.) A form of annual dividend policy is shown as Exhibit A (R. 98), and a form of deferred dividend policy, as Exhibit B (R. 110). The essential difference is that each annual dividend policyholder is entitled to receive on each anniversary date of his policy the amount of his overpayment for the preceding year as a "dividend" in cash, by a credit, or an abatement of the premium then due; but the deferred dividend policyholder is not entitled to this annual settlement. The overpayment made by him is left as a part of the aggregate ascertained overpayments and merged into the account in which are held the accumulated overpayments of all deferred dividend policyholders, except those on which a dividend is payable during the accountancy year. (Fifteenth paragraph, R. 46, 47.)

The deferred dividend policyholder loses or forfeits his annually ascertained overpayments if his policy lapses, or if he dies before the dividend date named in his policy. In that event they remain in the fund and are distributed among and paid to the survivors of his class whose policies are in force at the time the dividend becomes payable to the class. In that year each policyholder of the class receives a dividend made up of two items—first, his annually ascertained overpayments with accumulated interest, plus; second, his proportionate share of the accumulated overpayments of the members of his class who did not keep their policies in force and survive the accumulation period. (Seventeenth paragraph, R. 49.)

II

As to the claim for $3,324.67

The plaintiff owns a large amount of securities which it purchased at a premium. As a result of amortization it entered upon its books during the year 1913, as a loss sustained during the year, several sums which aggregated $332,466.72, representing the yearly proportion of the difference between the purchase price of the securities and par, which it would receive if it held the securities until maturity. The Circuit Court of Appeals reversing the District Court, held that this was not deductible. The sum of $3,324.67 is the tax of 1 per cent upon the amount thus claimed as a "loss."

III

As to the claim for $4,272.70

This sum represents a tax of 1 per cent upon $427,270, claimed by the company to be an addition required by law to be made within the year to its "reserve." This so-called addition to reserves is made up of three amounts, as follows:

(1) $16,629. In 1910 the plaintiff introduced into some of its life insurance contracts a clause by which it agreed, upon proof that the insured had become totally and permanently disabled, to waive payment of any premium thereafter falling due. The value on December 31, 1913, of the future premiums waived in accordance with such contracts was $16,629. The value on December 31, 1912, of the premiums thus waived was the sum of $5,637. In calculating the general reserve at the end of any year, the plaintiff and the New York Insurance Department deduct from the value of the contractual benefits under each policy the then value of all future premiums under the policy. The general reserve fund thus computed is the valuation of all policy obligations less the value of all future premiums, but under policies in which future premiums have been waived no future premiums will be received, and, therefore, the net reserve reported for these policies is understated to the extent of the value of these future premiums. In the official blank for the plaintiff's annual statement as

of December 31, 1913, there was an item of "liabilities" entitled "Present value of future premiums waived on account of total and permanent disability," and the plaintiff reported under that item the sum of $16,629, which was not included in the plaintiff's general reserve. In the official blank for report as of December 31, 1912, there was no such item, and the plaintiff included the item $5,637, the value of future premiums waived, as a part of its general reserve. If the sum of $5,637 had not been included as part of the general reserve on December 13, 1912, the net addition to the value of future premiums waived would have been the excess of $16,629 over $5,637; that is, $10,992. Since, owing to the change in form of the official blank, the sum of $5,637 was deducted as a part of the plaintiff's general reserve in obtaining the net addition to the general reserve, the sum to use in obtaining the net addition to the value of future premiums waived is $16,629. The Commissioner refused to allow this as a deduction, and the 1 per cent tax thereon is $166.29. (Twenty-second paragraph, R. 53, 54.)

(2) $250,000. At the end of each calendar year a considerable number of plaintiff's insured have died whose deaths have not been reported to the plaintiff during the calendar year. The superintendent of insurance requires the plaintiff to carry a special fund to meet its liability upon these unre-

ported losses. During the year 1913 the net addition to this fund was $250,000. The plaintiff in making its return deducted this amount as a reserve. The Commissioner refused to allow it. The 1 per cent tax upon that amount is $2,500. (Twenty-fourth paragraph, R. 55, 56.)

(3) $160,641. The plaintiff has a form of contract with many of its soliciting agents under which, after twenty years of continuous service showing a prescribed minimum of results, each of such agents becomes entitled to an income for life payable monthly, the amount being based upon the results obtained by him during the twenty-year period. The laws of New York require the superintendent of insurance, in making a valuation of the obligations of the plaintiff, to value annuities on the standard of McClintock's "Table of mortality among annuitants," with interest not exceeding 4 per cent. The superintendent required the plaintiff to carry a fund to meet its liabilities on these contracts, and the net addition to that fund during the year 1913 was $160,641. The plaintiff in making its return deducted this amount from gross income as a "reserve." The Commissioner refused to allow the deduction. The 1 per cent tax upon the amount thus disallowed was $1,606.41.

The Circuit Court of Appeals, affirming the District Court, held that these three items were deductible as "reserves."

ARGUMENT

I

The overpayments of premiums made by deferred dividend policyholders in 1912, ascertained in 1913, and added to the amount held for future distribution, were not deductible from plaintiff's 1913 income, because the amount thereof was neither paid back or credited to the individual policyholders who made them, nor treated as an abatement of premium of such individual policyholders in 1913

Both courts below properly held, upon the authority of *Penn Mutual Life Insurance Company* v. *Lederer*, 252 U. S. 523, that plaintiff's contention upon this branch of the case was without merit.

The plaintiff's claim is under that portion of the statute which provides:

> Life insurance companies shall not include as income in any year such portion of any actual premium received from any individual policyholder as shall have been paid back or credited to such individual policyholder, or treated as an abatement of premium of such individual policyholder, within such year.

which was the same provision of the same statute construed by this Court in the *Penn Mutual case*.

The question in that case was whether the Penn Mutual Life Insurance Company, a purely legal mutual reserve company issuing level premium policies, was entitled to deduct from its income for the year 1913, the aggregate amount paid during

that period by the company to its policyholders in cash dividends which were not used by them during that period, in payment of premiums. The several amounts making up the aggregate represented, mainly, a part of the so-called redundancy in premiums paid by the respective policyholders in some previous year or years. This Court held that the deduction was not allowable. In reaching that conclusion the Court discussed exhaustively the meaning and purpose of the statute, and held:

First. That the reason for the particular provision made by Congress is clear. Where the dividend, that is the overpayment of premium, was used to abate or reduce the full premium, the direction to eliminate from the apparent premium receipts is aptly expressed by the phrase " shall not include " used in the statute. Where the premium was left unchanged, but was paid in part by a credit or cash derived from the dividend, the instruction would be more properly expressed by a direction to deduct those credits, and Congress doubtless used the words " shall not include " as applied also to these credits, because it eliminated them from the aggregate of taxable premiums as being the equivalent of abatement of premiums.

The Court further held that the history of the " noninclusion " clause confirmed such construction of the intent of Congress, pointing out that while the provision in the Revenue Act of 1913, for

taxing the income of insurance companies, was in large part identical with the provision in the Excise Tax Law of 1909, the latter Act did not include the noninclusion clause. The Court discussed the case of *Mutual Benefit Life Insurance Company* v. *Herold,* 198 Fed. 199, decided July 29, 1912, and affirmed by the Circuit Court of Appeals on January 27, 1913, 201 Fed. 918, and concluded that the noninclusion clause of 1913—

> was doubtless framed to define what amounts involved in dividends should be "nonincluded," or deducted, and thus to prevent any controversy arising over the questions which had been raised under the Act of 1909.

The second conclusion of the Court was in answer to the argument that the nature of life insurance dividends is the same whatever the disposition made of them, and that Congress could not have intended to relieve the companies from taxation to the extent that dividends are applied in payment of premiums, and to tax them to the extent that dividends are not so applied. The Court pointed out that Congress had acted with entire consistency, but that the company had failed to recognize the principle, and said, page 530:

> The principle applied is that of basing the taxation on receipts of net premiums, instead of on gross premiums. The amount equal to the aggregate of certain dividends is excluded, although they are dividends, because by reason of their application the net

> premium receipts of the tax *year*[1] are to that extent less. There is a striking difference between an aggregate of individual premiums, each reduced by means of dividends, and an aggregate of full premiums, from which it is sought to deduct amounts paid out by the company which have no relation whatever to premiums received within the tax year but which relate to some other premiums which may have been received many years earlier. The difference between the two cases in such as may well have seemed to Congress sufficient to justify the application of different rules of taxation.

The Court then referred to a "further significant difference" (p. 531), and discussed the two elements which entered into modern life insurance, protection, and investment. When the dividend is applied in reduction of the renewal premium, Congress might well regard the element of protection as predominant and treat the reduction of the premium, paid by means of a dividend, as merely a lessening of the expense of protection. In deferred dividend and other semitontine policies, the dividend represents in part what clearly could not be regarded as a repayment of excess premium of the policyholder receiving the dividend, for what he receives is the share of the re-

[1] The word *year* does not appear in the official report, 252 U. S. 630. It does appear, however, in the opinion on file in the office of the Clerk of this Court and in the report in the Lawyer's Edition, Vol. 64, p. 702.

dundancy in premium of other policyholders, who did not persist in premium payments to the end of the contract period.

The third point discussed by the Court was devoted to a consideration of the relation in the Act between the provisions concerning mutual fire and mutual marine companies, and mutual life insurance companies. The Court concluded that the difference between protection and investment was again apparent. The service performed by fire and marine companies was purely protective, whereas that performed in level premium life insurance was both protection and investment.

In connection with the fourth point discussed, the Court said, page 536:

> Nor does the Government contend that any portion of a premium, not received within the tax year, shall be included in computing the year's gross income. On the other hand, what the company is seeking is not to have " nonincluded " a part of the premiums which were actually received within the year, or which appear, as matter of bookkeeping, to have been received but actually were not. It is seeking to have the aggregate of premiums actually received within the year *reduced* by an amount which the company paid out within the year; and which it paid out mainly on account of premiums received long before the tax year. What it seeks is not a *noninclusion* of amounts paid in, but a *deduction* of amounts paid out.

Applying the reasoning of the Court in the *Penn Mutual case* to the facts in the present case, it is apparent that plaintiff's argument for deduction or " noninclusion " of the amount in controversy is without merit. It is the aggregate of amounts received by the plaintiff in 1912, and not applied during the tax year 1913 by way of deduction or abatement of gross premiums received during 1913, and therefore has no relation to net premiums received during that year. Indeed, it can not be so applied. It must be held by the company and invested. No individual policyholder has the right to have any portion of it applied to the reduction or abatement of his premium. It is in the nature of a joint investment by him and all the other members of his class, to be divided among such members of that class as survive the accumulation period and maintain their policies in force to the end. If it can not be deducted or paid in cash, it may not be deducted or "nonincluded" while held for investment. Indeed, the plaintiff's position in the present case is not as strong as that of the plaintiff in the *Penn Mutual case*. In that case the amount in controversy had actually been paid back to individual policyholders.

No part of the amount here in controversy has been paid back to the individual policyholders or credited to any individual policyholder in any effective way, so that he has the right to, or control over, any portion thereof, either in abatement of

his premium or otherwise. The overpayments making up the sum in question, so far as the individual policyholder was concerned, were merely provisionally ascertained in 1913. They were not credited to the respective individual policyholders who made them. Despite the assertion in plaintiff's brief (p. 11) that they were so credited, the indisputable facts belie such contention. No deferred dividend policyholder could receive the dividend or overpayment in cash, nor could he use it to abate his 1913 premium or to purchase additional insurance. His contract precluded this. It provided (R. 113):

> THAT no dividend of surplus shall be allowed or paid upon this Policy, unless insured shall survive until completion of its DISTRIBUTION PERIOD, and unless this Policy shall then be in force.
>
> THAT surplus or profits derived from such Policies on the DISTRIBUTION POLICY PLAN as shall not be in force at the date of the completion of their respective DISTRIBUTION PERIODS, shall be apportioned among such Policies as shall complete the DISTRIBUTION PERIODS.

Not only did plaintiff not return these overpayments in 1913 to the deferred dividend policyholders, but it did not actually calculate the amount of overpayment made by any individual deferred dividend policyholder. It merely computed the rate on $1,000 of insurance for each year of issue, on each plan, and at each age, and recorded this rate of

overpayment on a form and bound the forms together, each year of issue in a separate volume. (R. 44.) It carried the aggregate in an account designated as " amounts set apart, proportioned, provisionally ascertained, calculated, declared or held waiting apportionment upon deferred dividend policies." This was in accordance with Section 103 of the New York Insurance Law, Chap. 28, Consolidated Laws of New York.

There is no basis for plaintiff's charge of discrimination. As pointed out by this Court in the *Penn Mutual case,* such so-called discrimination is due to the fact that Congress has acted with entire consistency in basing taxation on net premiums instead of on gross premiums. If the effect of the statute upon companies writing deferred dividend insurance differs from its effect upon companies not writing such insurance, the difference is due to the inherent distinction between the two forms of insurance. This difference affects both the policyholder and the company. That difference is made plain by this Court in the *Penn Mutual case* and was startlingly shown by the historic investigation made by a committee of the New York legislature in the year 1905, under the guidance of Honorable Charles E. Hughes, counsel for that committee. The report of that committee (Assembly Document No. 41, Report of the Joint Committee of the Senate and Assembly of the State of New York, appointed to investigate the affairs of life insur-

ance companies, transmitted to the legislature February 22, 1906), and its recommendations, subsequently enacted into law, worked a drastic change in the Insurance Law of that State. That report, page 418 *et seq.*, contains an elaborate discussion of the difference between annual dividend and deferred dividend insurance. The conclusion which it reached was that—

> No attempt should be made to disturb rights under existing contracts, but the issue of so-called deferred dividend policies in the future should be forbidden (p. 424).

This recommendation was adopted by the Legislature, Chapter 326, Laws of 1906, Insurance Law, Section 23, and since January 1, 1907, the writing of deferred dividend policies by mutual life insurance companies has been forbidden in that State.

The plaintiff attemps to distinguish the *Penn Mutual case* by claiming that dividends were held not to be deductible in that case, because they were "dividends" as distinguished from overpayments. Such, however, is not the point of the case. The dividends there were held to be nondeductible, not because they were dividends, but because they had not been applied to abate or reduce the current premiums of the respective policyholders, and, therefore, did not reduce the gross premiums of the company to net premiums.

On page 16 of the plaintiff's brief, referring to its method of carrying these amounts upon its books, it is stated:

> * * * The petitioner might have stopped there and let the total amount of the credited sums go into its general funds. But it did not do this. On the contrary, recognizing the true ownership of these credited sums, the petitioner maintained a special account into which it merged them, and it carried them and their interest accumulations in this separate account as a liability for the sole use and benefit of the several individual policyholders to whom they belonged.

This statement is, of course, inadvertent. The method used by the company in reporting this item was that required by Section 103 of the Insurance Law of New York.

II

The Revenue Act of 1913 does not permit the deduction from plaintiff's gross income for 1913 of the sum of $332,466.72, representing amortization of securities purchased at a premium

The Commissioner refused to allow this deduction. The District Court, however, overruled the Commissioner, but the Circuit Court of Appeals reversed the District Court. The Circuit Court of Appeals was clearly right.

No deduction can be allowed unless authority therefor is found in the language of the statute. Net taxable income is a purely statutory concept based upon the difference between statutory gross income and statutory deductions. It is not synony-

mous with actual net profit or gain, and may differ widely therefrom as shown by the books of the taxpayer upon sound principles of accounting. For instance, interest upon State and other bonds is expressly excluded from gross income, though of course it forms a part of actual income. Plaintiff's gross income, as restated by the Commissioner, was about $8,000,000 less than its gross income as reported to the Superintendent of Insurance. (R. 32.)

The amount representing amortization can be allowed under the statute only upon the theory that it is a loss " actually sustained within the year," or that it is " a reasonable allowance for depreciation by use, wear, and tear of property, if any." It would seem to be obvious that it is not a loss " actually sustained " within the year, although that is the ground alleged in the complaint (R. 10); nor is it deductible as " depreciation."

In *Fink* v. *Northwestern Life Insurance Company,* 267 Fed. 968, C. C. A. 7th Cir., a similar question arose under the Corporation Excise Tax Act of August 5, 1909, c. 6, Section 38, 36 Stat. 112. The court thought deduction by reason of amortization was not allowable, saying, page 971:

> There was no sale. The item arose from mere book adjustments. In our opinion, amortization of bonds does not come within any definition of " depreciation " under these or similar acts.

This Court in *Von Baumbach* v. *Sargent Land Company,* 242 U. S. 503, in discussing the meaning of depreciation under the Act of 1909, said, at page 542:

> What was here meant by "depreciation of property"? We think Congress used the expression in its ordinary and usual sense as understood by business men. It is common knowledge that business concerns usually keep a depreciation account, in which is charged off the annual losses for wear and tear, and obsolescence of structures, machinery, and personality in use in the business.

In the *Von Baumbach case* this Court refused to allow as depreciation of a mine, exhaustion of the ores. In the present case, the District Court allowed the deduction by analogy to the case of a trustee for a life tenant and a remainder man. In such cases it is well understood that if a trustee purchases bonds at a premium, he must reserve from the income accruing to the life tenant a sufficient sum to amortize the premiums paid so that the capital may be kept intact. Judge Mack said (R. 137):

> If in accordance with sound business and accounting methods the plaintiff has consistently distinguished between the yield of its investments and the amortization of its capital, I think the Commissioner of Internal Revenue erroneously treated the amounts amortized as income.

This reasoning, however, disregards the fundamental fact that we are dealing with a statutory definition of taxable income, not with a question of the relation between a life tenant and a remainderman. Moreover, a mutual life insurance company has no capital, life tenants, or remaindermen. Nor does the statute permit deductions merely because they are consistent with sound business and accounting methods.

In its report to the Insurance Department of New York the plaintiff included in gross income an amount of $279,361.96 as "appreciation." In restating the return (R. 32) the Commissioner deducted that amount from gross income at the same time that he disallowed depreciation as a deduction. Therefore, his rulings were entirely consistent. The plaintiff was neither charged with appreciation nor allowed depreciation.

The District Judge referred also to *New York Life Insurance Company* v. *Anderson,* 263 Fed. 527, another case under the Act of 1909, in which the Circuit Court of Appeals for the Second Circuit permitted this same company to revalue its securities in accordance with the prevailing market price and to deduct the loss as depreciation. It is not necessary to consider whether that case was properly decided, for a marking down of securities to their market value is not by any means the same thing as amortization. The amount we are considering here is not based upon market value. To

quote the agreed statement of facts (twenty-third paragraph, R. 54), it " represented the yearly proportion of the difference between par which the plaintiff would eventually receive upon securities owned by it if it held such securities until maturity, and the purchase price above par." The market price may have been greater than the purchase price. Even though that be not the fact in the present case, it illustrates our contention that the amount of annual amortization is not the same as a loss " actually sustained within the year "; nor does it necessarily represent actual depreciation in value.

The Circuit Court of Appeals, in reversing the District Court, referred to the fact that the District Judge had followed the doctrine laid down in the *Anderson case,* but pointed out that the language of the Act of 1913 differed from that of the Act of 1909. (R. 175.) This difference is important. The Act of 1909 permitted deduction of " a reasonable allowance for depreciation of property," whereas the Act of 1913 is much narrower, permitting only " a reasonable allowance for depreciation by *use, wear, and tear* of property." Furthermore, it should be noted that the plaintiff kept its books and reported to the insurance departments of the several States upon a cash receipts and cash disbursement basis (R. 57, folio 171), and that the Revenue Act of 1913 required the tax to be assessed upon a cash basis and not an accrual basis. See

Maryland Casualty Company v. *United States,* 251 U. S. 342. It is plain, therefore, that under this Act deduction for amortization could not be taken annually, but that the loss, if any, could be deducted only in the year such loss was actually sustained; that is, at the maturity of the securities, if the plaintiff held them until that time, or in any year prior thereto in which they were sold for less than cost. See also *Lumber Mutual Fire Insurance Company* v. *Malley*, 256 Fed. 383, wherein it was held that under the Act of 1909 neither increases in the value of securities were to be included in gross income nor decreases allowed as deductions.

Considering the language of the statute, the conclusion seems necessarily to follow that all interest payments made to plaintiff in 1913 constituted a part of its gross income and that no deduction therefrom was allowable for amortization.

III

Sums representing liability arising (a) because of waived premiums under special benefit disability contracts; (b) from unreported loss claims, and (c) upon pension contracts with agents, are not reserves within the meaning of the Revenue Act of 1913

The statute permits as a deduction by insurance companies, " the net addition, if any, required by law to be made within the year to reserve funds." This clause is the same as that contained in Section 38 of the Corporation Excise Tax of August

5, 1909, c. 6, 36 Stat. 112, and Section 12, Title I of the Revenue Act of September 8, 1916, c. 463, 39 Stat. 768. These provisions were construed with respect to fire and casualty insurance in *McCoach* v. *Insurance Company of North America*, 244 U. S. 585; *Maryland Casualty Company* v. *United States*, 251 U. S. 342; and *United States* v. *Boston Insurance Company*, decided November 23, 1925.

In considering this phase of the case we must again bear in mind the fact that taxable net income, under the revenue acts, is not synonymous with actual net income, profit, or gain. It is a statutory concept found by making statutory deductions from statutory gross income. The result is the amount which Congress has decided to be that portion of actual income properly the subject of taxation. While having no necessary relation to actual income, it is wholly removed from any actual relation to net worth, as shown by a balance sheet of assets and liabilities. Ordinarily liabilities are not allowed as deductions, any more than assets are made the subject of the tax, and deduction of the net addition to reserve funds is allowed only to insurance companies. The reason why Congress allowed a deduction of the legal reserve in the case of insurance companies is because the reserves of those companies bear a peculiar relation to the income of the companies, a relation inherent in the nature of the business which they conduct.

This Court said in *McCoach* v. *Insurance Company of North America,* 244 U. S. 585, at page 589:

> The act of Congress, on the other hand, deals with reserves not particularly in their bearing upon the solvency of the company, but as they aid in determining what part of the gross income ought to be treated as net income for purposes of taxation.

Insurance laws, in contrast to Income Tax statutes, are concerned chiefly with the solvency of the companies, that is, with balance sheets, not with profit and loss accounts. *McCoach* v. *Insurance Co. of North America,* 244 U. S. 585, 589.

We have already called attention to the theory of mutual, level premium life insurance. Companies conducting that business are purely cooperative associations in which each policyholder pays, as nearly as can be computed, the actual cost of the benefit which his contract gives him. The net or mathematical premium invested at an assumed rate of return, and taking into account the duration of life shown by mortality tables, is, without "loading," the exact amount which he, and all other members of his class, must pay annually in advance in order to put and keep the company in funds which will enable it to pay, as they mature, all the policies of those in his class. That amount is found by computing at the assumed rate of discount the present worth of the amounts which will be paid to all the members of the class, if they live

and die according to the experience tables, and dividing that amount ratably among all the members of his class. The legal reserve upon any policy, in any year, is the amount of the net premiums theretofore paid upon the policy, plus interest thereon at the assumed rate, less the cost of carrying the insurance up to that time, interest and cost being adjusted at the end of each year. In the aggregate, the reserve or " policy value " of a company may be found by deducting the value of all future net premiums from the present value of all policy obligations. *Moir Life Assurance Primer,* p. 148; *Eldridge, Principles of Reservation; Fackler, Notes on Life Insurance,* p. 33; *Principles and Practice of Life Insurance,* 8th Ed. (The Spectator Co.), p. 24. This is illustrated by a typical calculation made by Howard Payson Brown, Esq., Chief Actuary, United States Veterans' Bureau, printed as an appendix hereto. The reserve is also the amount which the company carrying the insurance would have to pay to another similar company to reinsure its risk.

By Section 21 of the Insurance Law of New York (Chap. 28, Cons. Laws, N. Y.) every life insurance corporation " whose assets and credits are not sufficient to reinsure its outstanding risks in a solvent insurance corporation, shall be deemed insolvent." After discharging, or making provisio for discharging, all its other obligations, its remaining assets must be at least equal to its legal reserve, or it is insolvent. But, of course, mere

technical solvency might not justify the State in allowing an insurance corporation to continue in business. To continue in business, a company should be not merely solvent but sound, with a safe margin of assets over and above the legal reserve, for it carries not only the savings of thousands of persons, but their provisions for the future based upon confidence and faith in the integrity of the structure which they are helping to build. The ship should be able to do something more than keep afloat. In so far as forethought can provide, she must be so seaworthy that she will weather all storms and carry her precious cargo safely to the end of the voyage.

To insure such stability is the purpose of the insurance laws and the duty of insurance superintendents. Stability, not net income, is their concern. Section 84 of the New York Insurance Law provides a legal basis for the valuation of all outstanding policies of life insurance companies. Section 86 of that law provides that in estimating the condition of any such company certain assets only shall be allowed, and that there shall be charged as liability—

> In addition to the capital stock, all outstanding indebtedness of the corporation, and the premium reserve on policies, and additions thereto in force computed according to the table of mortality and rate of interest prescribed in this article.

As mutual companies have no capital stock, the premium reserve on policies and all other outstand-

ing indebtedness are to be deducted from allowed assets in estimating the condition of the company; but Section 103 of the Insurance Law requires every annual report of every life insurance corporation, made to the Superintendent of Insurance, to contain " an accurate, concise and complete statement of the following matters." Then follows a list of 16 items, which collectively are intended to reflect with minute detail the exact condition of the company.

In the case of fire companies, the reserve is the " unearned premium " reserve. (Section 118, Insurance Law.) In the case of casualty companies there is an additional reserve for outstanding losses. (Section 86, Insurance Law.)

It is clear that under the laws of New York the only legal reserve of a life insurance company (except a " contingency reserve " under Section 87, not here involved) is the premium reserve, equivalent to the socalled " value " of its policies, the amount necessary to reinsure its risks. All its other obligations are " liabilities."

The application of these considerations makes clear the purpose of Congress in permitting insurance companies to deduct from gross income for any year the net addition to reserves required by law to be made during the year. The policy reserve of a life insurance company, together with the value of the future net premiums to be received, represents, as nearly as human wisdom can calculate it, the exact equivalent of the obligation exist-

ing at the moment under its policies, an obligation literally as sure as death itself. The net or mathematical premium (that is, the table premium less "loading") paid in advance when the policy is issued is, of course, at that moment the reserve on that policy. But reserves are computed at the end of the year, and by that time the initial reserve has been increased by interest and decreased by cost. The net addition made during the year, therefore, represents the exact equivalent of the net increase in the obligations assumed during the year. As overpayments of premiums returned or used as credits upon other premiums may be deducted from, or "nonincluded" in, gross premiums, since the intent of Congress was to base the tax upon net premiums (the *Penn Mutual case*), so it is proper that the portion of income added to the legal reserve should also be deducted, for it does not form part of the net income of the company. Thus the consistency of the statute is apparent. The reserve required by law is not part of net income, because it immediately becomes a liability. It does not increase the net income of a company any more than a deposit increases the net income of a bank.

The essential difference between the legal reserve of insurance companies, and various items to which the term "reserve" is sometimes applied in other matters of accounting, is apparent. It is also clear why Congress allowed insurance companies to deduct this particular item of liability

from gross income, and did not allow deduction of other liabilities by insurance companies or other companies. And while State Insurance Departments, with praiseworthy intent to make sure the solvency and stability of the companies under their supervision, require them to report in detail every item of liability and to have at all times beyond peradventure sufficient assets to discharge them, these liabilities, though sometimes called "reserves," are not the reserves meant by Congress in the Revenue Act. *McCoach* v. *Insurance Co. of North America,* 244 U. S. 585, 589.

This leads to consideration of the items in controversy.

(a) The sum of $16,629, the present value of premiums waived, was not a reserve within the meaning of the section

This sum represents the amount of future premiums which have been waived by the company under contracts whereby it agreed to do so upon proof that the insured had become totally and permanently disabled. Paragraph 22 of the agreed statement of facts (R. 53) indicates that the amount charged as a liability against these special benefit disability contracts was not regarded as part of the legal reserve even by the Superintendent of Insurance. It appears that in the official blank the sum of $16,629 was reported as an " item of liabilities." In the preceding year the plaintiff had reported the value of future premiums under these policies as part of its general reserve. Evi-

dently the Superintendent of Insurance, in changing the form of report for the companies, decided that it was improper to treat these future premiums as part of the reserve and so required them to be stated separately as an item of liability.

It is obvious that when policies of this kind were written the premium should have been, and doubtless was, computed by taking into consideration the probabilities of the insured becoming totally and permanently disabled. The premium would be the sum of two premiums, the life premium plus the disability premium. When disability occurs, that feature of the policy has matured. That obligation becomes an immediate liability represented by the present value of the future premiums on the life feature of the policy. It is apparent that the reserve upon such a policy would reflect the additional risk. See *Transactions Actuarial Society of America,* Vol. XVII, part 2, No. 56, pp. 211, 215, 223. The action of the Superintendent in requiring the present value of these waived premiums to be reported as a liability was, of course, proper and was required by Section 86 of the Insurance Law, which required all outstanding indebtedness to be charged as a liability. That liability, however, did not have the peculiar relation to net income which caused Congress to allow the deduction of the legal reserve. Indeed, these waived premiums might perhaps be regarded as sums to be paid by the plaintiff to itself on behalf of the policyholders

who had incurred permanent disability. In that sense it was a fund for the payment of incurred claims and therefore deductible only when actual payment was made. At any rate, it was not a reserve within the meaning of the term as construed by this Court in the *McCoach case,* 244 U. S. 585; the *Maryland Casualty Co. case,* 251 U. S. 342, and the *Boston Insurance Co. case,* November 23, 1925; and the fact that the Superintendent of Insurance of New York required it to be reported as a " liability " rather than as a reserve is significant. That official seems to be inclined to give the word " reserve " the broadest possible use, for in *United States* v. *Boston Insurance Company,* decided November 23, 1925, it appeared that he used that term to cover not only unpaid losses, estimated expense of investigations, and adjustments, but " all other outstanding liabilities due or accrued."

(b) The sum of $250,000, representing plaintiff's liability upon unreported losses, was not a "reserve"

This is a " loss claims reserve " similar to that which this Court held could not be deducted as a reserve in the *McCoach case,* 244 U. S. 585, and the *Boston Insurance case,* November 23, 1925. Those cases involved unpaid losses of fire insurance companies, but the principle is the same. Unpaid losses whether reported or not are immediate liabilities, not " reserves." Furthermore, the general reserve of the company, which was deductible, contained the proper reservation against these unreported

losses, and, when paid, they may be deducted, and the reserve against them released. While the estimated amount of unreported losses has no relation to statutory net income, it is obviously of importance to the Superintendent of Insurance in determining the exact financial condition of the company. This Court said in *McCoach* v. *Insurance Company of North America,* 244 U. S. 585, 589:

> There is a specific provision for deducting "all losses actually sustained within the year and not compensated by insurance or otherwise." And this is a sufficient indication that losses in immediate contemplation, but not as yet actually sustained, were not intended to be treated as part of the reserve funds; that term rather having reference to the funds ordinarily held as against the contingent liability on outstanding policies.

It is significant that in the twenty-fourth paragraph of the agreed statement of facts (R. 55) this sum is not referred to as a reserve but "as a special fund."

(c) The sum of $16,064, representing the value of annuities which the plaintiff had agreed to pay to certain of its agents was not a "reserve"

These "annuities" to agents were merely pensions given to them as compensation for services and have nothing to do with the life insurance business as such. In requiring the company to report

these obligations as liabilities the superintendent very properly estimated them upon the principle governing annuities. The twenty-fifth paragraph of the agreed statement of facts (R. 56) does not describe this amount as a reserve, however, but merely as a fund. These obligations, represented by a so-called reserve, could not have been within the contemplation of Congress when it provided for the deduction of " reserves required by law," for that term was there used in its technical sense. We have already shown that the deduction of " legal reserves " was allowed insurance companies because of the peculiar relation of the " reserve " to income in the insurance business. These obligations have no relation to the net income of the company, except in the years in which they are paid. No other corporations were allowed any such deduction. The situation here is no different from that of a railroad or industrial corporation or a bank which should have agreed to pay a faithful employee a pension for life, or which should have made a contract for life with an officer or agent. That the plaintiff is a life insurance company makes no difference. It is no part of the peculiar business of life insurance to pay pensions to agents, and obligations thus incurred are not the " reserves " meant by Congress when it used that word. That such arrangements as this are not regarded as a legitimate feature of the life insurance business, by the State which chartered the company, is

shown by the fact that Chap. 326 of the Laws of 1906 of New York prohibited all bonuses, prizes, and rewards, all increased or additional commissions and compensation based upon the volume of new or renewed business, or the aggregate of policies written or paid for, agreements with officers, trustees or salaried employees, for salary, compensation or emolument that would extend beyond the period of twelve months from the date of the agreement, and pensions to any officer, director, or trustee, or any member of his family after his death. These prohibitions are now found in Sections 97 and 98 of the Insurance Law.

These pensions are clearly in the nature of a business expense when paid, and while a business expense when paid is a proper reduction, a so-called reserve to take care of business expenses is clearly not a reserve as that term is used in the taxing statute. *Maryland Casualty Company* v. *The United States,* 251 U. S. 342, 350.

CONCLUSION

UPON THE QUESTIONS RAISED IN No. 712, THE JUDGMENT OF THE CIRCUIT COURT OF APPEALS SHOULD BE AFFIRMED; UPON THE QUESTIONS RAISED IN No. 804, IT SHOULD BE REVERSED.

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FEBRUARY, 1926.

APPENDIX

ILLUSTRATION OF CALCULATION OF POLICY VALUE, OR TERMINAL RESERVE, BY THE PROSPECTIVE AND RETROSPECTIVE METHODS

This may be illustrated by a typical case. The policy is an Ordinary Life policy for $1,000, taken out at the age of 35. The values are calculated in accordance with the American Experience Table of Mortality, interest earnings assumed to be at the rate of 3½ per cent compounded annually.

PROSPECTIVE METHOD

Value at the end of the first policy year:	
Present value of the benefit (Net Single Premium at the attained age) at the end of the first year	$377.9513
Present value, at the end of the first year, of the future net premiums to be received	366.1891
Difference equals the policy value, or terminal reserve, at the end of the first year	11.7622
Value at the end of the fifth policy year:	
Present value of the benefit (Net Single Premium at the attained age) at the end of the fifth year	410.0343
Present value, at the end of the fifth year, of the future net premiums to be received	347.3032
Difference equals the policy value, or terminal reserve, at the end of the fifth year	62.7311

RETROSPECTIVE METHOD

Net annual premium	19.9071
Add interest for one year at 3½ per cent	.6967
Sum	20.6038
Deduct cost of insurance first year	8.84
Terminal reserve, or policy value, at end of first year	11.7638
Add net annual premium	19.9071

Sum (initial value)	$31.6709
Add interest for one year at 3½ per cent	1.1085
Sum	32.7794
Deduct cost of insurance second year	8.87
Terminal reserve, or policy value, at end of second year	23.9094
Add net annual premium	19.9071
Sum (initial value)	43.8165
Add interest for one year at 3½ per cent	1.5336
Sum	45.3501
Deduct cost of insurance third year	8.90
Terminal reserve, or policy value, at end of third year	36.4501
Add net annual premium	19.9071
Sum (initial value)	56.3572
Add interest for one year at 3½ per cent	1.9725
Sum	58.3297
Deduct cost of insurance fourth year	8.94
Terminal reserve, or policy value, at end of fourth year	49.3897
Add net annual premium	19.9071
Sum (initial value)	69.2968
Add interest for one year at 3½ per cent	2.4254
Sum	71.7222
Deduct cost of insurance fifth year	8.99
Terminal reserve, or policy value, at end of fifth year	62.7322

NOTE.—The slight difference in the results from the two methods is caused by the number of decimals used in the intermediate values in the calculations. In practice the final result is cut off to the nearest cent.

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